No. 71-906

In The Supreme Court Of The United States

October Term 1971

MOUNTAIN FUEL SUPPLY COMPANY

vs.

UNITED STATES OF AMERICA

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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IN THE SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1971

No.

MOUNTAIN FUEL SUPPLY COMPANY, Petitioner

vs.

UNITED STATES OF AMERICA

Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

The Mountain Fuel Supply Company (the "Company") through its counsel, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Tenth Circuit in this case.

OPINIONS BELOW

The findings of fact and conclusions of law of the United States District Court for the District of Utah (Appendix A, *infra*, pp. 23-38) are reported unofficially at 26 AFTR2d 70-5100, 70-2 USTC para 9532. The opinion of the Court of Appeals (Appendix B, *infra*, pp. 39-57), reversing the district court decision and remanding to it, is reported at 449 F.2d 816.

JURISDICTION

The judgment of the Court of Appeals was entered on October 15, 1971. By order dated December 3, 1971, the petition of the Company for rehearing was denied. (Appendix C, *infra*, pp. 58-59). The juristiction of the Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

(1) REPAIRS. Whether the taxpayer's method of accounting is determinative under the requirements of Section 446 of the Internal Revenue Code in resolving whether expenses for repairs to capitalized depreciable properties should be deducted or capitalized and depreciated where such method (a) is prescribed by regulatory agencies, (b) has been consistently followed for many years, (c) clearly reflects income in its application, and (d) is not inconsistent with any statute requiring capitalization of such expenditures.

(2) DEPLETION. Whether, pursuant to Section 613 of the Internal Revenue Code, the Company is entitled to a full depletion allowance on crude condensate produced with natural gas and separated by an absorption plant in the field, where the Company is not an integrated producer with regard to the condensate, the condensate is sold at the field as crude petroleum to oil refineries, the condensate is the first commercially marketable product produced by the Company and the condensate is not chemically altered by the separation process.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions pertaining to the repair issue, Section 446 of the Internal Revenue Code and Section 1.446-1(a), (c) of the Treasury Regulations on Income Tax (1954 Code), and the depletion issue, Section 613 of the Internal Revenue Code and Section 1.613-3 of the Treasury Regulations on

Income Tax (1954 Code), are set forth in Appendix D, *infra* pp. 60-70.

STATEMENT

(1) REPAIRS. The Company, a regulated natural gas utility, operates a natural gas pipeline system in Utah and Wyoming consisting of approximately 400 miles of gathering or production lines, 900 miles of transmission lines, which connect the gathering lines to the distribution system, and 4,000 miles of distribution lines. (Appendix A, *infra*, pp. 24-25)

In the years, 1962, 1963 and 1964, the Company performed maintenance, repair and reconditioning work on certain segments of its high pressure production or gathering and distribution pipelines. Each segment involved and the year in which the work was done are as follows:

> In 1962 a 16" pipeline extending from the Company's Sunnyside station at the mouth of Emigration Canyon, south to 33rd South Street and west to Second West Street in Salt Lake City, a distance of 5.3 miles.
>
> In 1963 (1) an 8" pipeline extending from North Baxter Basin, north and east from Rock Springs, Wyoming to Kanda Junction, a distance of approximately 9 miles; (2) a 14" pipeline along or in the vicinity of Redwood Road extending from Indiana Avenue to 21st South Street, a distance of approximately 2.2 miles; (3) a 16" pipeline on 27th East Street extending from 13th South to 21st South in Salt Lake City, a distance of approximately .8 of a mile.

In 1964 (1) an 8" pipeline extending a distance of approximately three (3) miles from the West Hiawatha field to the junction of that line with the pipeline running from the East Hiawatha field to Kanda Junction; (2) a 10" pipeline extending from the Garfield Smelter to Tooele, a distance of approximately 12 1/4 miles; (3) an 8" pipeline extending from Tooele Junction to the International Smelting & Refining Company smelter, a distance of approximately two and one-half miles; (4) a 14" pipeline extending from the Sunset Station near the mouth of Weber Canyon to Roy, a distance of approximately 6 1/2 miles. (Appendix A, *infra*, pp. 25-26).

The nature of the work done on each of the segments involved was substantially the same. The gas was removed from the line, the pipeline was taken out of the ground, cut into 30 or 40 foot sections, hauled to a central yard, cleaned of the old coating, inspected, the corrosion pits and other defects spot welded, the section of the pipe not repairable cut out and replaced by new pipe, joined into the 30 or 40 foot sections by welding; hauled back to the original trench, mechanically bent to conform to the terrain where required, welded together along the trench, coated with coal tar and asbestos felt, reburied in the trench, pressure tested, covered up and put back into service. (Appendix A, *infra*, p. 26.)

In performing the work the Company removed expansion joints, stubs, dresser couplings, gate valves and irreparable pieces of pipe. These deletions, amounting to about ten percent of the total pipe

length, were replaced with new pipe and new valves. The replacements, including all relaying costs allocable thereto, were capitalized; the cost of digging up and removing retired pipe and fittings, less salvage, was charged to depreciation. reserve. The costs of removing, cleaning, repairing and relaying reuseable old pipe, except wrapping which was capitalized, were expensed and deducted. Approximately ninety percent of the old pipe was placed back in the trench. Allocation of all expenditures was made between expense and capital or depreciation reserve in proportion to the part (based upon the number of feet of pipe) which was replacement pipe and fittings and the part which was pipe and fittings that were repaired and reused. The total cost of the work in 1962 was $481,729.94 of which amount $360,117.81 was expensed, $110,659.59 was capitalized and $10,952.54 was charged to the depreciation reserve. The total cost of the work in 1963 was $376,801.42 of which $253,869.47 was expensed, $110,981.28 was capitalized and $11,950.67 was charged to the depreciation reserve. The total cost of the work in 1964 was $666,770.45 of which $456,130.53 was expensed, $199,322.40 was capitalized and $11,317.52 was charged to the depreciation reserve. (Appendix A, *infra*, p. 27).

The Federal Power Commission regulates the interstate transportation facilities of the Company and its system of accounting. The Utah Public Service Commission regulates its distribution operations, its system of accounting and its rates for gas service in Utah. The Company's method of accounting for and

allocating the costs of maintenance, repair and reconditioning work as between capital and expense is in accordance with the system of accounting adopted for natural gas companies by the Federal Power Commission and has been specifically prescribed by order of the Public Service Commission of Utah and is used by the Company in reporting its income to all government regulatory agencies to which it is required to report, including the Commissioner and to its shareholders. (Appendix A, *infra*, pp. 29-30).

The purpose of the Public Service Commission of Utah in prescribing the method of accounting in question is to determine and regulate the revenues which the Company is permitted to collect from its customers. The purpose of the Federal Power Commission in prescribing rules and methods of accounting and in auditing the books and records of the Company is to regulate the financial statements of companies engaged in the interstate transportation of natural gas. Those purposes are consistent with the aim of the Commissioner to the extent that all three are concerned with the clear and consistent reflection of income on the books of the Company with respect to pipeline repairs, replacements and improvements. The Public Service Commission of Utah and the Federal Power Commission have expertise in the field of natural gas production and distribution and in the accounting methods customarily used in that industry. The Company in charging the pipeline repairs to expense

has followed the consistent pattern and policy of those regulatory bodies and the orders of the Public Service Commission of Utah. (Appendix A, *infra*, pp. 30-31.)

The Company's accounting method for the repairs here in question is the same accounting method used by the Company since it began similar work in 1953. The method used by the Company reflects the consistent application of generally accepted accounting principles in the natural gas production, transmission and distribution industry and clearly reflects the income of the Company for income tax purposes. A change in such longstanding method by capitalizing the repairs in question would result in a distortion of the stated income of the Company by overstating the income for the years here involved and for a significant number of future years. (Appendix A, *infra*, p. 31.)

Section 446 (a) of the Internal Revenue Code, Appendix D, *infra*, p. 60, requires that: "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."

Section 446(b) of the Internal Revenue Code, Appendix D, *infra*, p. 60, states that, if it is determined that the method used by the taxpayer "does not clearly reflect income", then in that event the Commissioner may change the method to one which in his opinion does clearly reflect income. The Commissioner changed the Company's method of accounting for the repairs in question requiring all of

the expenditures to be capitalized and depreciated over the useful life of the assets and determined deficiencies accordingly. The Company paid the deficiencies, filed refund claims with the Commissioner which were rejected, and sued in the district court to recover the amount paid as taxes erroneously and illegally assessed. (Appendix A, *infra*, pp. 23-24).

The district court held that the Commissioner, by requiring the Company to capitalize the expenditures instead of allowing it to expense and deduct them for tax purposes, as the Company consistently had done since the first of such like expenditures were made in 1953, had changed the Company's method of accounting within the meaning of Section 446 of the Internal Revenue Code of 1954, that the method of accounting used by the Company clearly reflected the income of the Company, was proper and was binding upon the Commissioner as provided by Section 446(a), (b) of the Internal Revenue Code of 1954. The court of appeals reversed the decision of the district court and remanded for further proceedings in accordance with its opinion, holding that according to its tax accounting rule-of-thumb, the "general plan-of-betterment rule", all of the expenditures should have been capitalized and that "a reallocation of the expenditures in question between the two or three accounts cannot under the circumstances here present be regarded as contrary to Section 446 or to violate its purpose."

(2) DEPLETION. Natural gas is produced by the Company from leases in the Church Buttes field in Wyoming. The Company owns fifty-one percent (51%) of the reserves in the field; Union Pacific Railroad owns forty-nine percent (49%). No sales of gas are made at the wellhead. The Company and Union Pacific own proportionate shares of a separation plant in the field which separates water and the condensate from the gas. (Appendix A, *infra,* pp. 31-32).

The condensate which is in a vapor state under the high pressures and temperatures of the reservoir naturally condenses to a liquid state and drops out of the gas at surface temperatures and pressures. (Appendix A, *infra,* p. 32). By the time the gas flow reaches the separation plant, sixty-three percent (63%) of the condensate has already condensed to liquid in the gathering lines from the wells. (Appendix A, *infra,* p. 32). This condensate is removed by the inlet scrubber, a separation device at the plant. (Appendix A, *infra,* p. 33). The gas then passes through the absorber portion of the plant, where the remaining thirty-seven percent (37%) of the condensate is removed from the gas stream, (Appendix A, *infra,* p. 33). it were not so removed, it would condense in the transmission lines, (Appendix A, *infra,* p. 32). The gas then goes through another absorber unit, where water vapor is removed. (Appendix A, *infra,* p. 33). The gas then goes into the Company's transmission pipeline. The condensate separated by the absorber as well as the conden-

sate separated by the inlet scrubber is stored in a tank at the plant, from where it is sold to an oil refinery. (Appendix A, *infra*, p. 34). The Government did not challenge the depletion allowance on the sixty-three percent (63%) of the condensate separated by the inlet scrubber portion of the plant, but did challenge the depletion allowance on the thirty-seven percent (37%) of the condensate separated by the absorber portion of the plant.

The trial court found that the condensate separated was in no way altered by the processes of the separation plant or in any way broken down into refined petroleum products. (Appendix A, *infra*, p. 34). The trial court found that the substances which left the separation plant, dry gas, condensate and water, were the same as existed in the reservoir. The trial court held that taxes assessed upon the income derived from the sale of the condensate were illegally and erroneously assessed and paid because the Government did not allow full depletion on the condensate. The trial court held that the separation plant, and its processes, were part of the production process, and that the sale price of the condensate at the plant outlet was the depletable base for the condensate. (Appendix A, *infra*, pp. 36-37).

The Court of Appeals reversed and remanded, holding that the absorption process was a part of a manufacturing process and not an element of production, and that the depletion base for the Company's sales of the condensate had to be derived from representative market prices for wet gas, rather

than the condensate sale price at the outlet of the separation plant. (449 F.2d at 823, 824; Appendix, *infra*, p. 56).

REASONS FOR GRANTING THE WRIT

(1) REPAIRS.

(a) The decision below is in conflict with the decision of the Court of Claims in *Cincinnati, New Orleans & Texas Pac. Ry. v. U.S.*, 424 F.2d 563 (1970), 1/ and with the Seventh Circuit in *Van Pickerill & Sons, Inc. v. U.S.*, 445 F.2d 918. The Court below acknowledged the conflict observing (Appendix B, *infra*, p. 52) that the "authorities have extended Section 446 to accounting practices of more narrow scope than 'accounting methods'" but, nevertheless, held that the reallocation and capitalization of the expenditures here involved was not a change in method of accounting within the meaning of Section 446 of the Internal Revenue Code and that under the circumstances the purpose of Section 446 had not been violated. These conflicting decisions have created uncertainty and inequity in the application of Section 446 in cases where the Commissioner is exercising his apparent preference for capitalizing expenditures instead of allowing current deduction of them according to the established ac-

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1/ It is also in conflict with *Marsh Fork Coal Co. v. Lucas*, 42 F.2d 83, 85 (4th Cir. 1930); and *Fort Howard Paper Co.*, 49 T.C. 275 (1967).

counting method of the taxpayer. 2/

There are no significant factual differences between *Cincinnati Ry.* and this case. The critical facts are that in both cases the Commissioner had required capitalization and depreciation of expenditures which the taxpayers, pursuant to their long established methods of accounting, had deducted in the year the expenditures were incurred. In both cases it was found that the method of accounting for the expenditures was required or approved and ordered by the applicable regulatory agencies and was in accordance with generally accepted accounting principles and clearly reflected income for income tax purposes. In both cases the Commissioner claimed that a rule of thumb requiring capitalization of the expenditures was applicable, but there was no statute or other rule of law applicable to either case which directly required capitalization of the expenditures. The fact that different rules of thumb were pursued by the Commissioner is a distinction without a difference. 3/ While there are differences between *Van Pickerill* and this case,

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2/ In *Van Pickerill & Sons, Inc. v. U.S., supra,* 445 F.2d at 921, the Seventh Circuit noted:

> "[I]t appears that the decision by the Commissioner is more an expression of preference for capitalizing these charges rather than a determination that taxpayer's consistent use of its methods will not reasonably reflect income in the long run. . . ."

3/ In *Cincinnati Ry.* the Commissioner relied upon the one year rule of thumb that ordinarily assets having an expected useful life in excess of one year must be capitalized. 424 F.2d at 568. In the instant case the Commissioner has relied upon the "general-plan-of-betterment" rule of thumb, followed by the Tenth Circuit in *U.S. v. Wehrli,* 400 F.2d 686 (1968), and applied by it to this case.

those differences do not affect the legal issue as to the meaning and scope of the statutory phrase, "clearly reflects income." In *Van Pickerill*, the Commissioner attempted to require the addition of expenditures which taxpayer had consistently deducted when incurred to the cost of whiskey being held for aging and later sale. Since that case involved inventory, the Seventh Circuit applied Section 471 and the regulations thereunder which in all respects, pertinent to this case are comparable to Section 446.[4/] In all other respects the important facts are the same and the cases therefore raise the same legal question of the application of the clear reflection of income standard upon the taxpayer's method of accounting.

The differences in result between this case, *Cincinnati Ry.* and *Van Pickerill* cannot be ascribed to the facts[5/] but must be attributable to differing interpretations of the statute. The issue posed thus goes to the meaning and scope of Section 446 and is one that is appropriate for resolution by this Court.

(b) The application of Section 446 to this case is of importance to the Government and to innumerable

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4/ See Appendix D, *infra*, p. 60. Section 471 utilizes the "clearly-reflects-income" standard and the Regulations §1.471-2(b) in fashion similar to Regulations §1.446-1(a) (2) state that consistency of application and use of the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting income.

5/ The portion of the findings in this case which were held by the Tenth Circuit to be clearly erroneous does not affect or alter the findings of fact pertinent to this issue. See Appendix B, *infra*, pp. 50-51. See Findings 8, 14, 15 and 16, Appendix A, *infra*, at pp. 26, 29-31. Compare findings in *Van Pickerill & Sons, Inc. v. U. S.*, 25 AFTR2d 70-1232, 1970-1 USTC para 9391 (D.111. 1970).

taxpayers for it includes the question of whether the Government may impose a tax upon income which is generated solely by the imposition by the taxing authority of a different accounting method where the taxpayer's established method of accounting clearly reflects income. It is in the application of Section 446 that the Tenth Circuit is in conflict with the Seventh Circuit, the Court of Claims and the Tax Court.[6/] The Tenth Circuit has substituted its judgment as to the proper tax accounting practice for the tax accounting method of the taxpayer, measuring all by its own rule of thumb. The approach of the other courts has been to require conformity of the tax accounting to the taxpayer's method in those cases where the method clearly reflects income and is not inconsistent with statutes or rules of law specifying the tax accounting method.[7/]

The purpose of Section 446 is readily apparent. It requires the conformity of tax accounting to acceptable financial accounting methods of the taxpayer which have been consistently applied. The nationwide advantages of this conformity are also readily apparent. In a statement issued by the Board of Govenors of the American Institute of

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6/ The leading case in the tax court is *Fort Howard Paper Co.*, 49 T.C. 275 (1967). See also *Glenn v. Kentucky Color & Chemical Co.*, 186 F.2d 975 (6th Cir. 1951).

7/ E.g., *Fort Howard Paper Co.*, *supra*, 49 T.C. at 286.

Certified Public Accountants[8] favoring conformity of tax and financial accounting within certain limitations, it was noted:

> "Taxable income and accounting income are based on common information about transactions of a business. Thus, accounting methods used to compute taxable income agree, in most cases, with accounting methods used to compute accounting income for financial statements presented to investors and creditors. Taxpayers, the taxing authorities and the general public benefit to the extent that taxable income and accounting income conform because such conformity reduces the effort and cost of tax law compliance and administration, and tends to reduce confusion in financial reporting."

The Commissioner too is aware of the national importance of such conformity and of its advantages. Recent statements and new regulations illustrate this fact. In *News Release*, IR-1125, April 14, 1971, the Internal Revenue Service announced that it has undertaken a study on consistency of tax accounting methods and financial accounting methods. Pending completion of the study, the IRS will continue to require taxpayers who request consent to change tax accounting methods to conform to such tax methods for financial reporting purposes. On November 18, 1970, the Commissioner issued new final regulations under Section 446 defining "change in method of accounting," Regulations §1.446-1(e) (2), Appendix D, *infra*, p. 62. These new regulations

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8/ Statement On Conformity of Tax and Financial Accounting, Board of Directors of the American Institute of Certified Public Accountants, October 8, 1971.

are directly applicable to this case.[9/]

The national importance of the accounting method issue accentuated by the significant recent activity by the Commissioner relating to it make this case an appropriate one for review by this Court.

(c) This Court has not previously considered the application of Section 446 of the Internal Revenue Code to this kind of a case, however, the failure of the court below to apply the policy of conformity to financial accounting is in contradiction to the broad pronouncements of this Court concerning the proper judicial approach to the statute. In *Brown v. Helvering*, 291 U.S. 193, 204-05, 78 L.Ed. 725, 733 (1934), this Court noted that: "It is not the province of the court to weigh and determine the relative merits of systems of accounting."[10/] Until this Court provides a definitive solution, responsible government officials and private counsel will, as a practical matter, be unable to advise their respective

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9/ One of the examples stated in the regulations is in direct conflict with the decision of the court below as to whether or not a change in method occurred. Regulations § 1.446-1(e)(2)(ii)(a), (b) Appendix D, *infra*, pp. 63-65. By authority given the Secretary of the Treasury pursuant to Section 7805 of the Internal Revenue Code, the regulation has retroactive effect.

10/ In *Van Pickerill & Sons, Inc. v. U.S.*, *supra*, 445 F.2d at 921, the court stated:

"We do not believe, however, Congress intended the federal judiciary to decide, as a matter of law, accounting disputes where there is a wide diversity of expert opinion. . ."

In *All Steel Equipment, Inc.*, 54 T.C. 1749, 1762 (1970), it was said:

"If distinguished members of the accounting profession cannot agree on the best method of accounting in a given situation, courts should not undertake to make such a choice except in the most obvious cases."

clients to resolve problems such as those raised here, short of litigation. And, unless the Court resolves the present conflict in the courts, businesses in different parts of the nation will be taxed differently, even though they are involved in virtually identical commercial undertakings.

(2) DEPLETION.

(a) The decision of the Court of Appeals is in conflict with the principles applicable under the decisions of this Court. The Court of Appeals' opinion asserts that it finds its basic principles in four opinions of this Court: *United States v. Cannelton Sewer Pipe Co.*, 364 U.S. 76 (1960); *Commissioner of Internal Revenue v. Southwest Exploration Co.*, 350 U.S. 308 (1956); *Helvering v. Bankline Oil Co.*, 303 U.S. 362 (1938); and *Palmer v. Bender*, 287 U.S. 551 (1933) 449 F.2d at 823, Appendix B, *infra*, p. 54. The decision of the Court of Appeals, however, does not follow the principles announced in these cases. The *Palmer*, *Bankline* and *Southwest Exploration* cases were concerned with identifying the requisite economic interest in oil and gas reserves for a taxpayer to claim a depletion allowance, an issue that is not present in this case. The *Bankline* opinion however, quotes the tax court that "[N]atural gas, commonly known as wet gas as it flows from the earth, is not a salable comodity," (303 U.S. at 365) but this is as close as *Palmer*, *Bankline* or *Southwest Exploration* come to the depletion issue in this case. The *Cannelton Sewer Pipe* case *(supra)*, however, is di-

rectly in point with regard to the general principles involved in this case, though *Cannelton* was decided under a different subsection of the applicable regulations. This Court in *Cannelton* held that the taxpayer's gross income from mining (the depletion base) was the value of the fire clay and shale after application of ordinary treatment processes normally applied by nonintegrated miners engaged in the recovery of those minerals, 364 U.S. at 78, and that the Internal Revenue Code recognizes that mining operations may result in recovery of more than one mineral product in the raw state. 364 U.S. at 88. This Court reviewed the legislative history of the depletion statute and concluded that Congress intended to grant mineral producers a depletion allowance based on the constructive income from the raw mineral product and not on the value of the finished articles. 364 U.S. at 86.

The Court of Appeals' opinion in this case cannot be reconciled with the general principles outlined by this Court in *Cannelton*. The basic principle is simply to look at the product: If it is a raw mineral that is produced, then Congress intends that a percentage depletion be allowed on the costs of its production. If it is a manufactured, finished product, then Congress intends no depletion allowance to apply to the total costs of its manufacture. If the end product is raw clay, this Court has said in *Cannelton*, the costs of its production are fully depletable. If the end product is finished clay pipe, then the depletion base must be rolled back to the construc-

tive costs of the clay. If the end product is crude petroleum, it follows that the production costs are depletable. If the end products are those of an oil refinery, propane, butane, and automobile gasoline, then the total refining costs may not be used as the depletion base. The Court of Appeals, however, has not applied these principles in the cost, but instead has looked to the type of equipment used as the determinative factor. As a result, sixty-three percent (63%) of the crude condensate in the Church Buttes storage tank awaiting sale to an oil refinery was held to be a raw mineral product, and fully depletable, while thirty-seven percent (37%) of the same product in the same tank was held to be a manufactured finished article. The record shows, however, that the United States Geological Survey, for the purpose of determining royalty on this product, has determined that none of the product was manufactured.

(b) The Court of Appeals' opinion in this case is in conflict with the decisions of the Court of Appeals for the Fifth Circuit including *Shamrock Oil & Gas Corp. v. Commr.*, 346 F.2d 377 (5th Cir. 1965), upon which the court below relies. The development of the law in regard to the depletion allowance in cases involving "wet gas", natural gas containing condensate, has been logically consistant and fully in accord with the *Cannelton* principles. The *Shamrock* opinion and those leading up to it have consistantly looked at the product, not the type of equipment used in its production, as determina-

tive. In cases where field plants were constructed for the purpose of obtaining refined petroleum end products such as propane, butane and gasoline, the end products of the plant have been held *not* fully depletable products. *Brae Cannon Oil Co. v. Commr.*, 77 F.2d 67 (9th Cir. 1935); *Shamrock Oil & Gas Corp. v. Commr.*, 346 F.2d 377 (5th Cir. 1965). In the recycling cases where field separation plants produced only dry natural gas and crude condensate, the end products were held to be fully depletable products. *Edward J. Hudson v. Commr.*, 11 T.C. 1042 (1948), *aff'd*, 183 F.2d 180 (5th Cir. 1950); *Estate of Weinert v. Commr.*, 294 F.2d 750 (5th Cir. 1951); *Scofield v. La Gloria Oil & Gas Co.*, 268 F.2d 699 (5th Cir. 1959); *Panhandle Eastern Pipe Line Co. v. U.S.*, 408 F.2d 690 (Ct. Cl. 1969). The Court of Appeals' opinion in this case purports to be following *Shamrock*, but by an incorrect interpretation of *Shamrock* it abandons the principles laid down in *Cannelton* by this Court.

> The absorption process here was not followed by further processing as in *Shamrock*, but nevertheless, is not part of production nor necessary thereto. The fact that the condensate was further divided by fractionation in *Shamrock* was not a factor considered by the Fifth Circuit, and to us does not distinguish the case. 499 F.2d at 816, Appendix B, *infra*, p. 55.

The fact that the crude condensate separated from the gas in the Shamrock plant was then refined by fractionation into finished petroleum products was,

of course, considered in the Fifth Circuit and was, in fact, the basis of the *Shamrock* decision.

> "The absorption process used by Shamrock was clearly not an element of production, but was merely one of the steps in the manufacturing processes used by an integrated oil company in marketing the gas it produces." *Shamrock Oil & Gas Corp. v. Commr.*, 346 F.2d at 380.

Shamrock, like *Cannelton*, was an integrated producer - manufacturer. It made final, finished products, propanes, butanes, gasolines, etc., from the wet gas from its wells. The Fifth Circuit refused to accept the argument that they should hold that the absorption equipment was production equipment because they had so held in other fact situations, but instead, following the guidelines of this Court in *Cannelton*, the Fifth Circuit looked at what the final product of the taxpayer was. The Tenth Circuit in this case has done the opposite, and held that the absorption equipment of the Company was manufacturing equipment on the grounds that the Fifth Circuit so held in *Shamrock*.

(c) This Court should grant the writ because the Court of Appeals has decided an important question of federal law which has not been, but should be, settled by this Court. The decisions of this Court in "wet gas" cases, *Southwest Exploration, supra, Bankline, supra,* and *Palmer v. Bender, supra,* are not on point. Moreover, the fact that they were decided in a previous economic and technical era in the oil and gas industry deminishes the usefulness of their dicta.

This case is a particularly appropriate one for review by this Court of the question of determining the proper depletion allowance for wet gas production because this case involves neither an integrated producer-manufacturer of refined petroleum products, as did *Shamrock*, nor a cycling plant operation, as did the cases distinguished by *Shamrock*. Because the decision in this case will not be limited to those producers who refine condensate nor to those producers who pump the dried gas back into the reservoir, it can establish general principles which would be applicable industry wide, to oil and gas operations of all types. Because the decision below creates doubt as to those general principles, this Court should grant the writ and re-establish general principles which can be relied upon by the Government and the numerous producers of wet gas to the avoidance of further litigation.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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Of Counsel:
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APPENDIX A

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF UTAH CENTRAL DIVISION

MOUNTAIN FUEL SUPPLY COMPANY, Plaintiff,

v.

UNITED STATES OF AMERICA, Defendant.

FINDINGS OF FACT
AND
CONCLUSIONS OF LAW

Civil No. C232-69

This cause came on for trial on November 12, 1969, before Chief Judge Willis W. Ritter, and the court having heard the evidence and considered the stipulated pre-trail order, finds the facts and states the conclusions of law as follows:

FINDINGS OF FACT

1. Plaintiff, Mountain Fuel Supply Company, (the "Company") is a corporation organized and operating under the laws of the State of Utah.

2. The Commissioner of Internal Revenue (the "Commissioner") assessed deficiencies in the income tax of plaintiff for each of the years ending December 31, 1962, December 31, 1963 and December 31, 1964.

Plaintiff has paid all of the income taxes assessed against it for said years, together with interest on said deficiencies.

3. The Company timely filed refund claims for the tax years above referred to claiming that the deficencies were erroneously and illegally assessed and collected as follows:

Tax Year	Amount of Claim	
	Tax	Interest Paid
1962	$146,548.96	$42,318.34
1963	102,685.03	27,166.36
1964	268,990.43	55,137.73

The Company also timely filed refund claims claiming that it was entitled to refunds for carryback of unused investment credit from 1963 to 1962 in the amount of $44,878.53 and from 1965 to 1964 in the amount of $181,466.10. Prior to the commencement of this action, the Commissioner had either denied and rejected all of said claims and notified plaintiff of such denial and rejection by notice mailed by certified mail, or more than six months had elapsed since the filing of said claims, and no part of the amount claimed in any of said claims had been credited, refunded or paid to the plaintiff or to anyone for its account.

4. The grounds claimed by plaintiff for the refunds as set forth in this action are the same as those raised by it in its claims for refund.

5. The Company operates a natural gas pipeline system in Utah and Wyoming consisting of approxi-

mately 400 miles of gathering or production lines, 900 miles of transmission lines, extending from the terminus of the production or gathering lines to the distribution system, and 4,000 miles of distribution lines.

6. In the years, 1962, 1963 and 1964, the Company performed maintenance, repair and reconditioning work on certain segments of its high pressure production or gathering and distribution pipelines. Each segment involved and the year in which the work was done are as follows:

In 1962 a 16" pipeline extending from the Company's Sunnyside station at the mouth of Emigration Canyon, south to 33rd South Street and west to Second West Street in Salt Lake City, a distance of 5.3 miles.

In 1963 (1) an 8" pipeline extending from North Baxter Basin, north and east from Rock Springs, Wyoming to Kanda Junction, a distance of approximately 9 miles; (2) a 14" pipeline along or in the vicinity of Redwood Road extending from Indiana Avenue to 21st South Street, a distance of approximately 2.2 miles; (3) a 16" pipeline on 27th East Street extending from 13th South to 21st South in Salt Lake City, a distance of approximately .8 of a mile.

In 1964. (1) an 8" pipeline extending a distance of approximately three (3) miles from the West Hiawatha field to the junction of that line with the pipeline running from the East Hia-

watha field to Kanda Junction; (2) a 10" pipeline extending from the Garfield Smelter to Tooele, a distance of approximately 12 1/4 miles; (3) an 8" pipeline extending from Tooele Junction to the International Smelting & Refining Company smelter, a distance of approximately two and one-half miles; (4) a 14" pipeline extending from the Sunset Station near the mouth of Weber Canyon to Roy, a distance of approximately 6 1/2 miles.

7. The nature of the work done on each of the segments involved was substantially the same. The gas was removed from the line, the pipeline was taken out of the ground, cut into 30 or 40 foot sections, hauled to a central yard, cleaned of the old coating, inspected, the corrosion pits and other defects spot welded, the section of the pipe not repairable cut out and replaced by new pipe, joined into the 30 or 40 foot sections by welding, hauled back to the original trench, mechanically bent to conform to the terrain where required, welded together along the trench, coated with coal tar and asbestos felt, reburied in the trench, pressure tested, covered up and put back into service.

8. In performing the work the Company removed expansion joints, stubs, dresser couplings, gate valves and irreparable pieces of pipe. These deletions, amounting to about ten percent of the total pipe length, were replaced with new pipe and new valves. The replacements, including all relaying costs allocable thereto, were capitalized; the cost of digging up and

removing retired pipe and fittings, less salvage, was charged to depreciation reserve. The costs of removing, cleaning, repairing and relaying reuseable old pipe, except wrapping which was capitalized, were expensed and deducted. Approximately ninety percent of the old pipe was placed back in the trench. Allocation of all expenditures was made between expense and capital or depreciation reserve in proportion to the part (based upon the number of feet of pipe) which was replacement pipe and fittings and the part which was pipe and fittings that were repaired and reused. The total cost of the work in 1962 was $481,729.94 of which amount $360,117.81 was expensed, $110,659.59 was capitalized and $10,952.54 was charged to the depreciation reserve. The total cost of the work in 1963 was $376,801.42 of which $253,869.47 was expensed, $110,981.28 was capitalized and $11,950.67 was charged to the depreciation reserve. The total cost of the work in 1964 was $666,770.45 of which $456,130.53 was expensed, $199,322.40 was capitalized and $11,317.52 was charged to the depreciation reserve.

9. The work was done to repair defects and leaks in the pipe, to remove potential defects and to maintain the reliability of the line. The segments upon which the work was done were selected because of the history of leaks in the line and the location of the line. The leaks in the various segments could have been repaired by the Company on a leak by leak basis, as the leaks occurred, but the hazards and costs would have been greater and it would

not have been practical. There was no other practical way for the Company to repair the segments of the pipe here involved to maintain them in their ordinarily efficient operating condition without removing them from the ground, inspecting them for leaks and potential leaks and repairing the same. The pipe, prior to the repairs, could withstand pressures in excess of the customary use to which it was put; the new wrapping added no strength; after the work was done it was used at the same capacities and pressures as it was previously used, and each piece of pipe had the same capacity and ability to withstand pressure both before and after repairs.

10. The removal of defective pipe and unreusuable or unwanted fittings and valves and the replacement thereof with new pipe and new valves and fittings and the application of a new wrapping to the new and the old repaired pipe were incidental to the purpose of repairing the pipeline to maintain its reliability and prevent failures.

11. The segments of the pipelines involved are carried in composite depreciation accounts with an assigned useful life which is intended to be an average of the combined estimated lives of the various assets making up the composite account. The assigned composite account useful life used by the Company is 25 years for distribution pipelines and facilities and 14 years for production or gathering pipelines and facilities. The actual physical useful life of a specific segment of steel pipe cannot be accurately predicted, and certain pipelines or seg-

ments thereof physically exceed those assigned average useful lives and certain pipelines or segments thereof have shorter useful lives than those assigned. This is due to changes in sources of supply, gas consumption requirements and highway and road locations and to the physical characteristics of the soil in which the pipe is laid. The segments of steel pipe repaired by the Company had not reached the end of their useful life prior to the repairs and the deducted repairs did not appreciably prolong the useful life of said segments. Any possible addition to useful life is properly attributable to the incidental capitalized increments of the work.

12. The deducted repair work was not a part of any general plan of betterment, did not enhance the property's value and did not adapt the property to a different use. The portion of the expenditure allocable to capital was much smaller than the portion allocable to repair, and the primary purpose for making the expenditures was for repair.

13. The repairs which were charged to expense and deducted were not in the nature of replacements but were incidental repairs which neither materially added to the value of the reused pipe segments, nor appreciably prolonged their life, but kept such segments in an ordinarily efficient operating condition. The expenditures for said repairs were ordinary and necessary expenses paid or incurred in carrying on the trade or business of the Company.

14. The Federal Power Commission regulates the interstate transportation facilities of the Company

and its system of accounting. The Utah Public Service Commission regulates its distribution operations, its system of accounting and its rates for gas service in Utah. The taxpayer's method of accounting for and allocating the costs of maintenance, repair and reconditioning work as between capital and expense is in accordance with the system of accounting adopted for natural gas companies by the Federal Power Commission and has been specifically prescribed by order of the Public Service Commission of Utah and is used by the Company to report its income to all government regulatory agencies to which it is required to report, including the Commissioner and to its shareholders.

15. The purpose of the Public Service Commission of Utah in prescribing rules and methods of accounting for the Company is to regulate the revenues which the Company is permitted to collect from its customers and insure safe and efficient gas service to the public. The purpose of the Federal Power Commission in prescribing rules and methods of accounting and in auditing the books and records of the Company is to regulate the interstate transportation of natural gas. Those purposes are consistent with the aim of the Commissioner to the extent that all three are concerned with the clear and consistent reflection of income on the books of the Company with respect to pipeline repairs, replacements and improvements. The Public Service Commission of Utah and the Federal Power Commission have expertise in the field of natural

gas production and distribution and in the accounting methods customarily used in that industry. The Company in charging the pipeline repairs to expense has followed the consistent pattern and policy of those regulatory bodies and the orders of the Public Service Commission of Utah.

16. The Company's accounting method for the repairs here in question is the same accounting method used by the Company since it began similar work in 1953. The method used by the Company reflects the consistent application of generally accepted accounting principles in the natural gas production, transmission and distribution industry and clearly reflects the income of the Company for income tax purposes. A change in such longstanding method by capitalizing the repairs in question would result in a distortion of the stated income of the Company by overstating the income for the years here involved and for a significant number of future years.

17. The Church Buttes gas field, a deep gas condensate reservoir, is located approximately 50 miles west of Rock Springs, Wyoming. The wells are all located within five miles of a central separation and absorption plant (the "Plant"), the wells being connected to the Plant by lateral gathering lines through which all the product of the field flows after passing through line heaters located at or near the well head. The gas and condensate in the field are owned approximately 51 percent by the Company and 49 percent by Union Pacific Railroad Com-

pany, and the Company transports the natural gas produced from the field to its distribution system. The Company holds its interest under leases from the United States and the State of Wyoming. The Union Pacific Railroad Company owns its share of the field in fee and the Company and the Railroad each own a proportionate share of the Plant.

18. Liquid is produced with the gas. In the reservoir the liquid is in a vapor state, and, as the gas is produced from the sandstone formation, the liquids condense out because of the reduction of the pressure and temperature. The purpose of the Plant is to remove this liquid so that the gas is suitable for transmission in the Company's pipeline system. If the liquid condensate were not removed, the liquid hydrocarbons would condense in the pipeline and plug it unless removed. The Plant serves merely to separate the two natural products produced from the wells.

19. The condensation of part of the liquid hydrocarbons from the gas occurs naturally as the gas flows from the wells to the Plant. At the Plant, these liquids which have already condensed out of the gas are separated by a mechanical process at the Inlet Scrubber. About 63 percent of the liquid product is removed by the Inlet Scrubber, and this condensate does not go through the rest of the absorption plant and is placed in a storage tank from which it is sold. The Inlet Scrubber is commonly known as a mechanical separator or gravity separator. The mechanical separator is the type

that is commonly found at the well head. There is no mechanical separator on the lines that lead from the wells in the Church Buttes field to the Inlet Scrubber in the Plant. The Inlet Scrubber serves as a consolidated unit to perform that function for all wells. The consolidation of the scrubbing process is to achieve economic operation. The removal of the remaining liquid hydrocarbons could also be accomplished at each well head.

20. After the gas passes through the Inlet Scrubber, it goes through the absorber where the remaining liquid hydrocarbons, which would otherwise condense in the pipeline, are removed. There are two parts involved in the absorption portion of the Plant, the absorber and the stripping still. In the absorption unit the absorption oil dissolves, absorbs or soaks up liquid hydrocarbons from the gas. In the stripping still, these liquid hydrocarbons are removed from the absorption oil by applying heat and boiling off the liquid hydrocarbon product. Once the liquid hydrocarbons are boiled off, they are condensed to liquid form and placed in the storage tank, above mentioned, at atmospheric pressure and temperature.

21. After the gas stream passes through the condensate absorber, it passes through a water vapor absorber. The two processes, one for absorbing condensate and one for absorbing water, are identical in operations. The primary purpose of the water vapor absorber, as well as that of the condensate absorber, is to dry the natural gas to render it suit-

able for transmission by pipeline and use as a heating fuel.

22. The liquid hydrocarbons recovered at the Plant are not chemically altered at the Plant; they existed in a natural state in the reservoir. The Plant does not refine the gas or the liquid hydrocarbons into finished petroleum products such as propane, butane or natural gasoline, but merely separates the liquid hydrocarbons from the gas. The process of the Plant is a separation process, not a fractionation process which produces converted or refined petroleum products.

23. The liquid hydrocarbons which are separated from the gas by the Plant are sold at the storage tank at the Plant as crude petroleum to an oil refining company, which commingles it with the crude oil that goes into its refinery.

24. The U. S. Geological Survey, which regulates the Church Buttes federal leases of the Company, has officially held that pursuant to the provision in the leases requiring payment of royalties to the United States "on the amount of all production from the leased lands" the Company must pay royalty on production measured at the outlets of the Church Buttes plant. This was based upon a determination by the U. S. Geological Survey that the Church Buttes plant was a production facility and not a manufacturing facility manufacturing refined petroleum products.

25. It was stipulated by the parties that the Company is entitled to the carryback of an unusued

investment credit from the tax year ending December 31, 1963 to the year ending December 31, 1962, in an amount to be computed based upon the determination of this court of the other issues in this case.

CONCLUSIONS OF LAW

1. The jurisdiction of the Court in this proceeding is founded upon 28 U.S.C. §1346(a) (1).

2. In determining the amount of the taxable income of the Company for federal income tax purposes for its tax years ending December 31, 1962, December 31, 1963 and December 31, 1964, the Company is entitled to deductions in the amounts of $360,117.81 for 1962, $253,869.47 for 1963 and $456,130.53 for 1964 for sums which the Company expended for maintenance and repairs to its pipelines in those years which were not allowed as ordinary and necessary business expenses by defendant and for which income taxes have been illegally and erroneously assessed and paid, because such repairs were incidental repairs which neither materially added to the value of the property nor appreciably prolonged its life, but kept it in an ordinarily efficient operating condition within the meaning of Section 1.162-4 of the Income Tax Regulations and were deductible under Section 162(a) of the Internal Revenue Code of 1954 as ordinary and necessary expenses paid or incurred in carrying on the trade or business of the Company.

3. The Commissioner, by requiring the Company to capitalize the expenditures instead of allowing it

to expense and deduct them for tax purposes, as the Company consistently has done since the first of such like expenditures were made in 1953, seeks to change the accounting treatment of an item which affects the income tax liability of the Company and as such has changed the Company's method of accounting within the meaning of Section 446 of the Internal Revenue Code of 1954. The Commissioner erroneously and illegally changed the Company's method of accounting and as a result income taxes have been illegally and erroneously assessed and paid and the Company is entitled to deductions for repairs in the amounts above stated pursuant to its method of accounting, because such method clearly reflects the income of the Company for tax purposes, is proper and is binding upon the Commissioner as provided by Section 446 of the Internal Revenue Code of 1954.

4. In determining the amount of the taxable income of the Company for federal income tax purposes for its tax years ending December 31, 1962, December 31, 1963 and December 31, 1964 the Company is entitled under Section 613 of the Internal Revenue Code of 1954 and its applicable regulations to percentage depletion in the amounts of $29,621.34 for 1962, $29,398.40 for 1963 and $27,894.94 for 1964 upon the gross income from the production of liquid hydrocarbons produced with the natural gas from the Church Buttes field and for which income taxes have been illegally and erroneously assessed and paid; because the purpose of the Church Buttes

plant is to aid in the production of natural gas, the processes of the plant are processes associated with the extraction of gas and condensate from the reservoir, and the crude condensate or liquid hydrocarbons are not manufactured or converted into a refined product nor transported from the premises prior to sale and the sale price of the condensate at the outlet of the plant is the gross income from the property with regard to such product.

5. In determining the amount of the federal income tax of the Company for its taxable year ending December 31, 1962, it is entitled to a credit for carryback of unused investment credit as required by § 46 of the Internal Revenue Code of 1954 from the year ending December 31, 1963 to said year 1962, in an amount to be computed based upon the determination of this court of the other issues in this case.

6. The amount of carryback of unused investment credit from years following the years here under consideration is not an issue in this proceeding within the meaning of Section 6511(d).(4) (B) of the Internal Revenue Code of 1954 and the decision of this Court, after it has become final, shall not be conclusive with respect to the investment credit, and the effect of such credit, to the extent that such credit is affected by a carryback from years later than the years here in issue to the years here in issue.

Dated this 1st day of June, 1970.

WILLIS W. RITTER, CHIEF JUDGE

APPENDIX B

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

No. 605-70 - SEPTEMBER 1971 TERM

MOUNTAIN FUEL SUPPLY COMPANY, Appellee, v. UNITED STATES OF AMERICA, Appellant.	Appeal From The United States District Court For The District of Utah Central Division (D. C. # C-232-69)

Grant W. Wiprud, Attorney, Tax Division, Department of Justice (Johnnie M. Walters, Assistant Attorney General, Meyer Rothwacks and Issie L. Jenkins, Attorneys, Tax Division, Department of Justice, and C. Nelson Day, United States Attorney, of Counsel, with him on the Brief), for Appellant.

J. Wendell Bayles and Edward J. McDonough, Salt Lake City, Utah (Joseph S. Jones and John Crawford, Jr., Salt Lake City, Utah, with them on the Brief), for Appellee.

Before SETH, ALDISERT*, and McWILLIAMS, Circuit Judges.

*Of the Third Circuit, sitting by designation.

SETH, Circuit Judge.

This is an action to recover income taxes paid by the Mountain Fuel Supply Company, for the years 1962, 1963, and 1964. The company is engaged in the business of producing natural gas and operating pipelines for the gathering, transmission, and distribution of natural gas. This appeal concerns two unrelated issues. One is the proper depletion base for the condensate produced by the taxpayer from wells or leases it owns or in which it has an interest. The second issue is whether or not it was proper for the taxpayer to have deducted, under section 162 of the Internal Revenue Code of 1954, as a necessary business expense, certain costs incurred by it in reconditioning portions of its pipeline.

THE PIPELINE RECONDITIONING

To consider first the issue relating to the deductions made for ordinary and necessary business expense, the record shows that the deductions in issue as made by the company in 1962 amounted to $360,117.81, in 1963 $253,869.47, and in 1964 $456,130.53. Of the total expenditures made by the company in reconditioning segments of its line, $1,070,117.81 was deducted as expense, and $420,963.27 was treated as "new investment." The company operates some 900 miles of transmission lines, about 4,000 miles of distribution lines, and 400 miles of gathering lines. About forty miles of lines were reconditioned during the years in question in the manner hereinafter described. The segments reconditioned were in ser-

vice at the time, and it was necessary to put them out of service, to remove the gas from the pipe, to dig up the pipe, and remove it from the ground. The trench was then temporarily backfilled. The pipe was then cut into thirty or forty foot sections and hauled to a central location where it was straightened. The old couplings, expansion joints, stubs, old valves, and defective welds which had not been cut out in the field were cut out. The remaining portions were cleaned by the removal with knives and sandblasting of the exterior coating which had been applied when they were originally laid. The interior of the pipe was also cleaned. Small corrosion pits and other small defeats were spotwelded, but portions of the pipe which were in such condition that they could not be so repaired were cut out and were replaced by new sections. The pipe sections were beveled, transported back to the original trenches where they were bent where necessary to conform to the terrain, the trench reopened, the sections of pipe welded together, new valves inserted where needed, the pipe coated with coal tar and a fabric covering, replaced in the trench, tested, the trench backfilled, and the segment put into service.

The record shows that of the total length of pipe which was initially removed from the ground, approximately ten per cent thereof was replaced with new pipe and new valves. The new pipe, as indicated above, replaced the portions not considered repairable, the old expansion joints, and the fittings which had been removed. The new valves which

were installed were plug valves to replace the original gate valves.

The taxpayer, for the years in question, handled the reconditioning costs on its books and records as follows: The cost of the new pipe to replace the footage discarded, and the cost of new valves was capitalized, as was the relaying cost and the company overhead applicable to such new portions. The cost of digging up and removing the portions of the line which were discarded, less slavage, was charged to depreciation reserve. The cost of recoating and wrapping the old pipe returned to service and the cost of coating and wrapping the replacement portions was capitalized. The cost of digging up, cutting, removing, hauling, straightening, cleaning, spotwelding the corrosion pits, removal of defective sections, beveling, bending, reopening trenches, rewelding, relaying, testing, and burying of all the old pipe returned to service was expensed. Much of the reconditioning was done by independent contractors.

The portions of the corporation's lines with which we are here concerned were laid in 1929, 1930, and 1931. The segments selected for reconditioning were portions of the lines which had a bad history of leaks. The company had engaged in some relatively limited reconditioning heretofore, but for the most part had handled leaks in the lines on an individual basis when they occurred. For depreciation the company accounting had placed the lines in a composite account with a useful life of twenty-five years.

The trial court found:

> "The work was done to repair defects and leaks in the pipe, to remove potential defects and to maintain the reliability of the line. The segments upon which the work was done were selected because of the history of leaks in the line and the location of the line."

The trial court also found that the work done was not a part of any general plan of betterment, did not enhance the property's value, and did not adapt the property to a different use. The court also found that the portions charged to expense were not replacements but, were incidental repairs which did not appreciably prolong the life of the pipe reused, but kept the segment in operating condition. The court thus concluded that the expensed costs were ordinary necessary expenses paid or incurred in carrying out the company's business, and gave judgment for the taxpayer.

As indicated above, the deductions were made as necessary expenses under section 162 of the Internal Revenue Code of 1954. This section provides in part without elaboration that ". . .all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . ." may be allowed as a deduction. Section 263 of the 1954 Code provides that a deduction may not be made for the expenses incurred for the acquisition of any buildings, for permanent improvements, or for "betterments made to increase the value of any pro-

perty. . . ." This same section also precludes deductions for amounts spent in "restoring property or in making good the exhaustion thereof for which an allowance is or has been made." Pursuant to the Code provisions, the Treasury Regulations provide in section 1.162-4 in part: "The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in ordinarily efficient operating condition, may be deducted as an expense. . ." This same section also states:

> "Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with section 167 or charged against the depreciation reserve if such an account is kept."

The Treasury Regulations relating to capital expenditures, section 1.263(a)-1, provide that a deduction may not be allowed for betterments made to increase the value of the property nor for amounts paid to "substantially prolong the useful life" of property or equipment. This same subsection also states: "Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the meaning" of the subparagraphs concerned.

As indicated in our decisions hereinafter cited, these regulations are of long standing and were early construed by the Board of Tax Appeals in the frequently cited case of Illinois Merchants Trust

Co., 4 B.T.A. 103. There the Board indicated that the purpose for which the expenditures were made was an important factor and went on to state:

> "A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired."

The Board contrasted expenditures made for such purposes with those improvements or additions which prolonged the life of the property.

This court, in Hotel Kingkade v. Comm'r, 180 F.2d 310 (10th Cir.), considered expenditures which had been made in connection with the operation of a hotel. These expeditures were for carpets, kitchen equipment, appliances, fans, roofing, tile work, and a variety of other expenditures. We there said that the expenditures therein made were such as to materially add to the value of the property and appreciably prolong its life as an operating hotel. It was held that such expenditures were of a capital nature. In Denver & Rio Grande R. R. v. Comm'r, 279 F.2d 368 (10th Cir.), the issue concerned expenditures made by the taxpayer upon an old wooden viaduct. These expenditures consisted of installing new wooden floor planks over most of the viaduct and some new stringers for the support of the viaduct and to stiffen the structure. The railroad had expensed the entire amount, and the Tax Court

had found that the expense should have been capitalized. We held that the Tax Court was correct and stated that:

> "The expenditure resulted in a substantial restoration, strengthening and improvement of the viaduct. It was not for incidental repairs but for a replacement of a major portion of the viaduct which could no longer be repaired. The improvements so made had a useful life of many years."

A similar issue, together with the acquisition of additional property, was considered by this court in United States v. Akin, 248 F.2d 742 (10th Cir.).

The taxpayer in United States v. Wehrli, 400 F.2d 686 (10th Cir.), had made expenditures in connection with the alteration and refurbishing of an office building for a new tenant. The expenditures had been deducted as expense. We there again examined the regulations and the definitions which had been adopted by this court and also by the Fifth Circuit in Jones v. Comm'r, 242 F.2d 616 (5th Cir.), and other cases therein cited. Also we considered the issue as to whether or not the expenditures had been made, or certain elements thereof had been made in accordance with a general plan for rehabilitation, modernization, or improvement of the property. Reference was made to the "general plan" concept in 4A Mertens, Law of Federal Income Taxation, section 25.41, and to I. M. Cowell v. Comm'r, 18 B.T.A. 997, and followed in a series of cases therein cited. The doctrine is that where such a plan for

rehabilitiation existed and expenditures were made thereunder, and although particular portions of the work could otherwise be properly classified as expenditures, the entire expenditure made in accordance with the plan must be capitalized.

In the light of the regulations and of the cases cited, an application of the Code to the facts appearing in the record leads us to the conclusion that the costs incurred in the rehabilitation of the pipeline, as described above, constituted expenditures not in the ordinary course of business, but for the betterment of the segments of the line so treated, and also substantially prolonged the life of such segments.

The work of rehabilitation is centered about the recoating and rewrapping of the pipe. The segments selected, as above indicated, were those with a history of leaks and which had reached or passed the period initially assigned as their useful life. The record contains testimony on the purpose of the recoating and rewrapping of the pipeline which states it was done to protect the pipe as it had been when initially laid, but in a better way. The result thus was to start another life span for the reconditioned segments of the line. In order to accomplish the recoating and rewrapping, it was necessary to unearth the pipe and to remove such of the old coating and wrapping as remained thereon in order that the new coating and wrapping could be applied. In connection therewith, the antiquated couplings, expansion joints, and unused stubs and old valves were re-

moved. Likewise sections of the pipe which had corroded to such an extent that it was not worthwhile to recoat and rewrap them were removed. One of the witnesses for the taxpayer testified, and reference was made to a section of pipe laid in 1929 or 1930 and to its estimated physical life. He indicated that it was reconditioned at that time and ". . .so therefore the physical life was approaching the end." The witness indicated that it was approaching the end by reason of the possibility of leaks and of corrosion. He thereupon stated in effect that the pipe would be able to stay in the ground over a longer period of time because of the new coating and wrapping. He was asked: "The coating will allow it—prolong the life of the pipe?", to which he answered, "It should." The following series of questions and answers ensued, the witness having stated that the pipe itself was no more durable but upon rehabilitation became more reliable, and stated:

"Q. Does it have any longer life,—a physical life?

"A. Longer life than it had before?

"Q. Yes.

"A. It was reconditioned?

"Q. Yes.

"A. Yes, it could last a heck of a long time."

The witness Coleman testified as follows:

"Q. Yes. Would it be correct to state that the purpose of this reconditioning process was to make the reconditioned pipe the structural equal of new

pipe insofar as practical?

"A. I think that is a fair statement."

The company in its report to the Public Service Commission of Utah relative to part of the proposed reconditioning program stated that the original pipe was some thirty years old and was reaching the point where there was danger of breaks. It further reported that the reconditioned pipeline should have a life in excess of forty years, and through the installation in transmission lines of high pressure valves, such a line would be able to operate at pressures of 700 to 800 pounds in contrast to the pressure of the old lines at 400 pounds. The record makes further reference to the capability of the line to withstand a higher working pressure in a letter from the taxpayer to the Public Service Commission of Utah, dated April 9, 1963. This increased capability is in part attributed to the installation of the plug valves to replace the old gate valves, as well as the elimination of certain expansion joints and couplings. An official of the taxpayer testified that the new valves were better able to stand the higher pressure than the old valves. Upon replacement of the segments of the reconditioned line in the ground, it was pressure-tested at considerably higher pressures than had been used at any time theretofore. It is obvious that any individual length of the pipe could withstand no higher pressure than it had theretofore, but it is equally apparent that when an entire segment of the line

had been reconditioned as above indicated, with the elimination of the old style couplings and joints and the installation of plug valves, the segment so rehabilitated could operate at higher pressures, and consequently be able to transport a greater volume of gas. The record thus clearly demonstrates that the reconditioning was done not to enable the pipeline to continue to operate during its initial estimated life, but was instead accomplished to enable the pipeline to begin a new period of expected life. This purpose and result of the reconditioning places the expenditures clearly within the capital improvement category. The record before us in our opinion leads to no other conclusion, and we must hold that the finding of the trial court to the contrary was clearly erroneous.

The significance of a plan of rehabilitation or improvement is referred to in United States v. Wehrli, 400 F.2d 686 (10th Cir.). The record here contains portions of statements made to the Public Service Commission of Utah, and proposals for the expeditures to be made upon the various segments of taxpayer's pipelines. These references with maps demonstrate that the taxpayer embarked upon a program for rehabilitation of the designated portions of its pipelines. Mr. Simon, an official of the taxpayer, testified that the company began a reconditioning program in 1962, but had theretofore done some reconditioning work. The witness testified "this program" included in all some 257 miles of pipeline. A similar reference appears in correspondence with the Utah

Public Service Commission. It is apparent that a general plan of rehabilitation, used in this sense, need not encompass all of the properties of the taxpayer or even all of one particular category of property. The taxpayer urges that the previous authorities relating to the "general plan" issue concerned the expenditures made upon a building or similar structures, and that these cannot be compared to its pipeline system. However, in view of the statements and maps submitted by the taxpayer to the Public Service Commission, and the references in the record, it is apparent that the taxpayer did embark upon a particular program of rehabilitation which was well defined in scope and was of considerable significance in view of its overall operations and funds available. The record in our opinion cannot support the finding of the trial judge that there was no such plan of rehabilitation, and consequently we must hold that such finding was clearly erroneous.

The taxpayer urges that the allocation of the expenditures between additions to capital and expenses as proposed by the government would amount to a change in its accounting "methods" contrary to section 446 of the Internal Revenue Code. This section in part provides that: "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." This has been construed to refer to "generally accepted accounting practices," Fort Howard Paper Co., 49

T.C. 275, and to direct primary consideration to whether income is clearly reflected, Cincinnati, New Orleans & T. P. Ry. v. United States, 424 F.2d 563 (Ct.Cl.). The taxpayer urges that similar allocations have been made in prior years, and were not contrary to the rules of the several regulatory agencies having jurisdiction over taxpayer. The authorities have extended section 446 to accounting practices of more narrow scope than "accounting methods"; however, a reallocation of the expenditures in question between the two or three accounts cannot under the circumstances here present be regarded as contrary to section 446 or to violate its purpose. We have previously considered the implications of the commissioner's determination that the "method" clearly reflects taxable income. See Harden v. Comm'r, 223 F.2d 418 (10th Cir.), and Jones v. Trapp, 186 F.2d 951 (10th Cir.). Consistency in treatment of particular transactions is of great importance in utility accounting, but an erroneous allocation should not be perpetuated on the basis of consistency. The accounting "methods" required by regulatory agencies do not necessarily dictate the proper income tax treatment for expenditures. Old Colony R.R. v. Comm'r, 284 U.S. 552. They do, however, demonstrate a reason why some accommodation should be made when possible.

We thus hold that the commissioner was correct in assessing the deficiencies he did as to the income tax returns of the taxpayer for each of the years ended December 31, 1962, December 31, 1963, and Decem-

ber 31, 1964, insofar as such deficiencies were based upon the allocation of expenses incurred by the taxpayer in reconditioning its pipelines, the subject of this action.

THE DEPLETION BASE FOR TAXPAYER'S SALE of CONDENSATE

Natural gas is produced by taxpayer from leases in the Church Buttes field in Wyoming. It owns about fifty-one per cent of the reserves in the field and the Union Pacific Railroad owns the balance. No sales of raw gas are made by taxpayer at the wellhead. The two companies also own proportionally a plant near the field which separates the water and the hydrocarbon liquids from the gas produced from the field. There is no separation made at or near the wellheads; instead it is done for all the wells at the central plant. As the gas enters this plant, it passes through the inlet scrubber. This device separates the then liquid hydrocarbons, condensate, from the incoming stream. The liquids so derived are stored for a time and sold to refiners. The gas after this separation still contains hydrocarbons which are liquefiable at temperatures and pressures which may be encountered in the pipelines before the gas reaches the ultimate customer and thus should be removed to prevent accumulation in the lines. At taxpayer's plant these are removed by the absorption method which utilizes oils to absorb the liquefiable hydrocarbons in the gas. This oil with the condensate absorbed by it is then heated in a still and the two are then separated by condensation. The con-

densate portion is placed in storage to be sold, and the absorbing oil is reused. The gas also contains some water vapor when produced, and this is also removed in the plant by a vapor absorber or contactor using diethylene glycol. The absorption methods utilized in this plant do not change chemically the condensate, and no fractionation of the condensate is attempted — that is, it is not further separated into its components. The condensate is instead placed in storage tanks and sold as such to refiners.

The United States Geological Survey which is the agency which administers the taxpayer's federal leases in the Church Buttes field requires the taxpayer to pay royalty to the government based on the values at the completion of the processing at the plant on the theory that no "manufacturing" takes place at the plant, and it is instead part of the production of the gas.

The trial court concluded that the absorption plant, and its processes, were part of the production process, and that the sale price of the condensate at the plant outlet was the depletable base for this product.

The relevant limitations of the depletion allowance are set out in United States v. Cannelton Sewer Pipe Co., 364 U.S. 76; Commissioner v. Southwest Exploration Co., 350 U.S. 308; Helvering v. Bankline Oil Co., 303 U.S. 362, and Palmer v. Bender, 287 U.S. 551, and need not be repeated here. The present Treasury Regulations relative to the matter

appear at section 1.613-3(a). It is sufficient to say that the income upon which the allowance may be applied is to be that derived from production, gross income from the property, and not on any manufacturing costs which may be added. The issue thus becomes whether or not the absorption process here used is a part of or essential to production or whether it is a manufacturing process. The point where production ceases and manufacturing begins was of course the issue in the Cannelton case, and the related cases which followed including the limestone-cement cases.

We are here concerned only with the depletion base for the condensate, but again the production-manufacturing division must be made. The government here relies strongly on Shamrock Oil & Gas Corp. v. Comm'r, 346 F.2d 377 (5th Cir.), which also considered an absorption plant operated by an integrated oil company, and which adopted the decision of the Tax Court in the same case (35 T.C. 979). We also refer to the Tax Court decision. The Circuit Court thus held that the absorption process there used, and which is the same as here used, was part of the manufacturing process and not an "element of production." The court also distinguished its prior decisions in Weinert's Estate v. Comm'r, 294 F.2d 750 (5th Cir.), and in Scofield v. La Gloria Oil & Gas Co., 268 F.2d 699 (5th Cir.), where a recycling process was considered. In the case before us, we reach the same conclusion as was reached in Shamrock. The absorption process here was not followed by fur-

ther processing as in Shamrock, but nevertheless is not part of production nor necessary thereto. The fact that the condensate was further divided by fractionation in Shamrock was not a factor considered by the Fifth Circuit, and to us it does not distinguish the case.

The absorption process here used was apparently necessary or advantageous in the subsequent marketing of the gas by the taxpayer, or perhaps necessary before long distance movement of the gas took place, but this is not the test. Thus in the record, the reason advanced for the removal of liquids or liquefiable vapors from the gas was that their presence would interfere with the passage of the gas through the pipelines. It was testified that the hydrocarbon liquids would collect in low portions of the line and block the passage of gas. Also the witnesses stated that the water vapor in the gas would lead to the creation of compounds which would have a like effect. Thus the plant was designed to remove these materials to enable the gas to be transported for marketing. This marketing reason required the process which because of this purpose was manufacturing as distinct from production.

The depletion base for the condensate thus must be derived from representative market prices for wet gas, and the condensate sales price at the outlet of the absorption plant cannot be used as the base.

No issue was raised or considered on this appeal relative to a credit for carryback of unused invest-

ment credit.

The case is REVERSED and REMANDED for further proceedings in accordance with this opinion.

APPENDIX C

SEPTEMBER TERM, OCTOBER 15, 1971

Before Honorable Oliver Seth, Honorable Ruggero J. Aldisert*, and Honorable Robert H. McWilliams, Circuit Judges.

(*Of the Third Circuit)

MOUNTAIN FUEL SUPPLY COMPANY,
Appellee,
vs.
UNITED STATES OF AMERICA,
Appellant.
No. 605-70

This cause came on to be heard on the record on appeal from the United States District Court for the District of Utah, and was argued by counsel.

On consideration whereof, it is ordered that the judgment of said court is reversed and cause is remanded for further proceedings in accordance with the opinion of this Court.

HOWARD K. PHILLIPS, Clerk.
By Heide Barthel
Deputy Clerk.

A true copy
Teste
Howard K. Phillips
Clerk, U.S. Court
Appeals, Tenth Circuit
By Heide Barthel
Deputy Clerk

NOVEMBER TERM - DECEMBER 3, 1971

Before Honorable Oliver Seth, Honorable Ruggero J. Aldisert* and Honorable Robert H. McWilliams, Circuit Judges.

(*Of the 3d Circuit)

MOUNTAIN FUEL SUPPLY COMPANY,

Plaintiff-Appellee,

v.

UNITED STATES OF AMERICA,

Defendant-Appellant.

No. 605-70

Upon consideration of petition of appellee for rehearing, it is ordered that said petition is denied.

A true copy
Teste

Howard K. Phillips
Clerk, U.S. Court of
Appeals, Tenth Circuit
By Heide Barthel
Deputy Clerk

APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) *General Rule.*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) *Exceptions.*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

* * *

SEC. 471. GENERAL RULE FOR INVENTORIES.

Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the grade or business and as most clearly reflecting the income.

SEC. 613. PERCENTAGE DEPLETION

(a) *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or roy-

alties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under section 611 be less than it would if computed without reference to this section.

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

* * *

TREASURY REGULATIONS

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

1.446-1 *General Rule for methods of accounting.*

(a) *General Rule.* —(1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Ex-

cept for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.* * *

* * *

(e) *Requirement respecting the adoption or change of accounting method.* * * *

(2) (i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or

not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.

(ii) (a) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder), a change from the cash or accrual method to a long-term contract method, or vice versa (see §1.451-3), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a change where the Internal Revenue Code and regulations thereunder specifically require that the consent of the Commissioner must be obtained before adopting such a change.

(b) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such

as errors in computation of the foreign tax credit, net operating loss, percentage depletion or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction which does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, correction of items that are deducted as interest or salary, but which are in fact payments of dividends, and of items that are deducted as business expenses, but which are in fact personal expenses, are not changes in method of accounting. In addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts or an adjustment in the useful life of a depreciable asset. Although such adjustments may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustments in the current and future years. For the treatment of the adjustment of the addition to a bad debt reserve, see the regulations under section 166 of the Code; for the treatment of a change in the useful life of a depreciable asset, see the regulations under section 167 (b) of the Code. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. On the other hand, for example, a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which had been consistently treated as an expense in the year of purchase involves the question of the

proper timing of an item, and is to be treated as a change in method of accounting.

(c) A change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting.

(iii) A change in the method of accounting may be illustrated by the following examples:

Example (1). Although the sale of merchandise is an income producing factor, and therefore inventories are required, a taxpayer in the retail jewelry business reports his income on the cash receipts and disbursements method of accounting. A change from the cash receipts and disbursements method of accounting to the accrual method of accounting is a change in the overall plan of accounting and thus is a change in method of accounting.

Example (2). A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis except for real estate taxes which have been reported on the cash receipts and disbursements method of accounting. A change in the treatment of real estate taxes from the cash receipts and disbursements method to the accrual method is a change in method of accounting because such change is a change in the treatment of a material item within his overall accounting practice.

Example (3). A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis. Vacation pay has been deducted in the year in which paid because the taxpayer did not have a completely vested vacation pay plan, and, therefore, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make the payment now rises. The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed.

Example (4). From 1968 through 1970, a taxpayer has fairly allocated indirect overhead costs to the value of inventories on a fixed percentage of direct costs. If the ratio of indirect overhead costs to direct costs increases in 1971, a change in the underlying facts has occurred. Accordingly, an increase in the percentage in 1971 to fairly reflect the increase, in the relative level of indirect overhead costs is not a change in method of accounting but is a change in treatment resulting from a change in the underlying facts.

Example (5). A taxpayer values inventories at cost. A change in the basis for valuation of inventories from cost to the lower of cost or market

is a change in an overall practice of valuing items in inventory. The change, therefore, is a change of method of accounting for inventories.

Example (6). A taxpayer in the manufacturing business has for many taxable years valued its inventories at cost. However, cost has been improperly computed since no overhead costs have been included in valuing the inventories at cost. The failure to allocate an appropriate portion of overhead to the value of inventories is contrary to the requirement of the Internal Revenue Code and the regulations thereunder. A change requiring appropriate allocation of overhead is a change in method of accounting because it involves a change in the treatment of a material item used in the overall practice of identifying or valuing items in inventory.

Example (7). A taxpayer has for many taxable years valued certain inventories by a method which provides for deducting 20 percent of the cost of the inventory items in determining the final inventory valuation. The 20 percent adjustment is taken as a "reserve for price changes." Although this method is not a proper method of valuing inventories under the Internal Revenue Code or the regulations thereunder, it involves the treatment of a material item used in the overall practice of valuing inventory. A change in such practice or procedure is a change of method of accounting for inventories.

Example (8). A taxpayer has always used a base stock system of accounting for inventories. Under

this system a constant price is applied to an assumed constant normal quantity of goods in stock. The base stock system is an overall plan of accounting for inventories which is not recognized as a proper method of accounting for inventories under the regulations. A change in this practice is, nevertheless, a change of method of accounting for inventories.

* * *

1.471.2 Valuation Of Inventories

* * *

(b) It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with §§1.471-1 to 1.471-9. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

* * *

1.613-3 Gross income from the property

(a) Oil and gas wells. In the case of oil and gas wells, "gross income from the property", as used in

section 613(c) (1), means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation.

(b) Minerals other than oil and gas —(1) In general. The term "gross income from the property," as used in section 613(c) (1), means, in the case of a mineral property other than an oil or gas property, gross income from mining. "Gross income from mining" is that amount of income which is attributable to the processes of extration of the ores or minerals from the ground and the application of mining processes, including mining transportation. For the purpose of this section, "ordinary treatment processes" (applicable to the taxable years beginning before Jan 1, 1961) and "treatment processes considered as mining" (applicable to the taxable years beginning after Dec. 31, 1960) will be referred to as "mining processes." Processes, including packaging and transportation, which do not qualify as mining will be referred to as "nonmining processes." Also for the purpose of this section, transportation which qualifies as "mining" will be referred to as "mining transportation" and transportation which does not qualify as "mining" will be referred to as "nonmining transportation." See para-

graph (f) of this section for the definition of the term "mining" and paragraph (g) of this section for rules relating to nonmining processes.

No. 71-906

Supreme Court, U.S.
FILED

In the Supreme Court of the United States.

OCTOBER TERM, 1971

MOUNTAIN FUEL SUPPLY COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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In the Supreme Court of the United States

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The findings of fact and conclusions of law of the district court (Pet. App. A 23-38) are not reported. The opinion of the court of appeals (Pet. App. B 39-57) is reported at 449 F. 2d 816.

JURISDICTION

The judgment of the court of appeals was entered on October 15, 1971 (Pet. App. C 58). A petition for rehearing was denied on December 3, 1971 (Pet. App. C 59). The petition for a writ of certiorari was filed on January 12, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether petitioner's expenditure of more than $1,000,000 under a general program for reconditioning and reconstructing older portions of its pipeline system constitutes a capital expenditure within the meaning of Section 263 of the Internal Revenue Code, rather than an ordinary and necessary business expense deductible under Section 162.

2. Whether petitioner is entitled to percentage depletion, under Section 613 of the Code, on gross sales of the condensate (liquid hydrocarbons) which it removes from wet gas by absorption processes.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 162, 263, 446 and 613 of the Internal Revenue Code of 1954, and of Treasury Regulations on Income Tax (1954 Code), Sections 1.162-4, 1.263(a)-1 and 1.613-3 are set forth in the Appendix, *infra*, pp. 15-19.

STATEMENT

I. *Petitioner's expenditures for reconditioning and reconstructing portions of its pipeline system.*

Petitioner operates a natural gas pipeline system consisting of some 5,300 miles of gathering, transmission, and distribution lines. During the taxable years 1962, 1963 and 1964, petitioner expended approximately $1,500,000 in reconditioning and reconstructing segments of its lines, totalling about 40 miles, which had been laid in 1929, 1930 and 1931, and which had a bad history of leaks. Prior to 1962, petitioner had, for the

most part, handled the leaks on an individual basis as they occurred. The segments involved were carried by petitioner for depreciation purposes in a composite account with a useful life of 25 years. By 1962, they had reached or passed the period initially assigned as their useful life. (Pet. App. B 40, 42, 47.)

Of the $1,500,000 expended, approximately $500,000 was paid for new pipe, new valves, the recoating and wrapping of old and new pipe, and the digging up and removal of discarded pipe and fittings. A portion of the $500,000 was capitalized, and the remainder was charged to the depreciation reserve. This treatment is not in dispute. The balance, more than $1,000,000, was paid for reconditioning and reconstructing the old pipe and restoring it to service. Petitioner expensed the $1,000,000 on its books, in required reports filed with governmental agencies, including the Federal Power Commission, and on its income tax returns. The Commissioner disallowed the deductions, and petitioner, after paying the tax in dispute, brought this suit for refund. (Pet. App. A 30; Pet. App. B 40, 42.)

The district court found that the expensed portion of the work was not part of any general plan of betterment, but consisted of incidental repairs which neither materially added to the value of the reused pipe segments, nor appreciably prolonged their life. It accordingly held that the costs of such work were deductible business expenses. The court also ruled that capitalizing such costs would change petitioner's longstanding method of accounting, and would distort rather than clearly reflect its income. (Pet. App. A 29, 31.)

The court of appeals concluded from the record that

the reconditioning was undertaken not to permit the pipeline to continue to operate during its initial estimated useful life, but rather to enable the pipeline segments to begin a new period of expected life. The court also found that the work was done as part of an overall plan of rehabilitation which was significant in relation to petitioner's overall operations and available funds. It reversed the district court's findings to the contrary as clearly erroneous, and held that the costs in question were capital expenditures to be depreciated over the new period of expected life of the pipeline. (Pet. App. B 47, 50-51.) The court further held (Pet. App. B 52) that "a reallocation of the expenditures in question between the two or three accounts cannot under the circumstances here present be regarded as contrary to section 446 [relating to methods of accounting] or to violate its purpose."

II. *The absorption plant processes which yield saleable condensate*

Petitioner and the Union Pacific Railroad are 51 and 49 percent owners, respectively, of the reserves in the Church Buttes gas field in Wyoming. The wet gas produced from the field contains liquid hydrocarbons and water in a vapor state. Petitioner does not sell this wet gas at the wellhead. Rather, the gas is piped directly from the wells to a central separation and absorption plant owned by petitioner and Union Pacific. About 63 percent of the liquid hydrocarbons condenses naturally as the wet gas flows from the wells to the plant, is separated by a mechanical process at the plant's Inlet Scrubber, stored, and sold to refiners. The Inlet Scrub-

ber is a mechanical or gravity separator of a type commonly found at the wellhead. (Pet. App. A 31-32; Pet. App. B 53.)

The gas entering the plant after passing the Inlet Scrubber still contains liquefiable hydrocarbons, and these are reduced to condensate and removed from the gas in two stages. First, oils absorb the liquefiable hydrocarbons, thus removing them from the gas; then the absorbed hydrocarbons are removed from the oil by boiling them off with heat, reduced to a condensate, stored, and sold as crude petroleum to refineries. No chemical change is involved in these processes. The water vapor is also removed from the gas by absorption processes. The removal of the condensate and water leaves a dry gas which is suitable for transmission by pipeline and used as a heating fuel. (Pet. App. A 33-34; Pet. App. B 53-54.)

In the case of oil and gas wells, Section 613(a) and (b)(1) of the Internal Revenue Code of 1954, Appendix, *infra*, pp. 16-17, as effective during the years in issue, authorized a depletion deduction of 27½ percent of the "gross income from the property." The question in the case at bar is what constituted petitioner's "gross income from the property" with respect to the condensate derived from the wet gas by absorption processes. Treasury Regulations on Income Tax (1954 Code), Section 1.613-3(a), Appendix, *infra*, pp. 18-19, provides that:

> In the case of oil and gas wells, "gross income from the property," * * * means the amount for which the taxpayer sells the oil or gas in the im-

> mediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation.

The rulings of the courts below turned upon their conclusions as to whether the absorption processes involved were conversion (manufacturing) processes, or were simply part of the extractive phase of petitioner's operations. The district court, taking the view that the absorption processes were part of petitioner's extractive operations, ruled that petitioner's depletable "gross income from the property [condensate produced by absorption]" was its gross sales thereof (Pet. App. A 36-37). Reversing, the court of appeals concluded that the absorption processes were conversion processes yielding marketable products, not extractive processes. It accordingly held that the depletion base of the condensate was not petitioner's gross sales, but a lesser constructive amount derived from representative market or field prices for the wet gas petitioner extracted from the ground.[2] (Pet. App. B 56.)

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[2] The U.S. Geological Survey, which administers petitioner's Church Buttes federal leases, requires petitioner to pay royalties to the government based on values of gas and condensate after the completion of processing in the plant, on the theory that the plant is not a manufacturing facility but merely a production facility associated with extraction of the wet gas from the ground (Pet. App. A 34; Pet. App. B 54).

ARGUMENT

The decision below is correct. There is no conflict or any other reason for further review.

I. *Petitioner's expenditures for reconditioning and reconstructing portions of its pipeline system*

1. Section 162(a) of the Internal Revenue Code of 1954, Appendix, *infra*, p. 15, authorizes the deduction of ordinary and necessary business expenses. Treasury Regulations on Income Tax (1954 Code), Section 1.162-4, Appendix, *infra*, p. 17, characterizes as deductible business expense, subject to certain provisos, the "cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition * * *." Section 263(a) of the Code, Appendix, *infra*, p. 15, provides that expenditures are capital in nature and nondeductible where they are "for permanent improvements or betterments made to increase the value of any property," or are "expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made." These limitations are elaborated in Regulations under Code Sections 162 and 263(a). Section 1.162-4, Appendix, *infra*, p. 17, classifies as nondeductible the cost of repairs "in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property * * *." Somewhat similarly, Section 1.263(a)-1(b), Appendix, *infra*, pp. 17-18, provides that expenditures may not be deducted if they

"add to the value, or substantially prolong the useful life, of property * * *."

The court of appeals here determined that the pipeline segments involved had reached or passed the period initially assigned as their useful life; that the reconstruction and reconditioning work was done under a general program of rehabilitation; that the program was significant in relation to petitioner's operations; and that the result of the work was to start another life span for the reconditioned segments. Given the court's findings, its conclusion that the costs in question are capital expenditures is the only conclusion compatible with the terms of Sections 162, 263, and the regulations thereunder. Petitioner does not argue to the contrary; it has simply ignored all of these provisions.

Petitioner instead relies on Section 446, Appendix, *infra*, pp. 15-16, which provides as a general rule that taxable income shall be computed under the method of accounting regularly employed by the taxpayer in keeping its books, but further provides that if the taxpayer's method does not clearly reflect income, the computation of taxable income shall be made in such manner as does clearly reflect income. The result is the same, however, whether the question here is approached under Sections 162 and 263, or under Section 446. The findings of the court of appeals that the costs in question were part of a single plan of rehabilitation, were significant in relation to petitioner's operations, and enabled the pipeline segments to begin a new period of useful life preclude the conclusion that the expensing

of such costs would clearly reflect petitioner's income within the meaning of Section 446.[2]

2. There is no conflict, even in principle, with *Cincinnati, New Orleans & Texas Ry. Co.* v. *United States*, 424 F. 2d 563 (Ct. Cl.), or *Van Pickerill & Sons, Inc.* v. *United States*, 445 F. 2d 918 (C.A. 7), as petitioner contends (Pet. 11-13). Both arose on wholly different facts. The *Cincinnati, New Orleans* case involved the railroad's practice of expensing items of property costing less than $500, in accordance with Interstate Commerce Commission regulations.[3] In *Van Pickerill*, the issue was whether the taxpayer's method of accounting for its inventory of bulk whiskey clearly reflected its income, where taxes, insurance premiums and storage costs were deducted currently, rather than added to inventory. In each case it was held that the taxpayer's method of accounting was proper because, among other things, the taxpayer was able to show that its taxable income would have been approximately the same whether it used its own method of accounting or the

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[2] Petitioner claims (Pet. 6, 12) that its practice was in accordance with generally accepted accounting principles and with Federal Power Commission and Utah Public Service Commission requirements. But there was testimony below to the contrary (see p. 62 of the record appendix in the court of appeals), and, in any event, it is settled that the rules of accounting prescribed by a regulatory agency are not binding for tax purposes. See *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552; *Commissioner* v. *Lincoln Savings and Loan Assn.*, 403 U.S. 345.

[3] The same regulations prohibit expense treatment where two or more items are purchased as part of a single plan, and the total cost of all items purchased is $500 or more. See *Cincinnati, New Orleans & Texas Ry. Co.* v. *United States*, *supra*, 424 F. 2d at 565-566.

method proposed by the government. Where, as here, on the other hand, the expenditure is found to be substantial in relation to the taxpayer's operations, its treatment as a current expense, rather than as a capital expenditure, necessarily will have a material effect on the computation of taxable income.[4]

II. *Depletion on the condensate produced by the absorption processes*

The depletion allowance is "based on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit," and "is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired." *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308, 312. A taxpayer must look solely to income derived from extraction for a return of his capital through the depletion allowance. *Palmer* v. *Bender*, 287 U.S. 551, 557; *Commissioner* v. *Southwest Expl. Co.*, *supra* at 314. As this Court explained in *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 88, depletion is not designed "to recompense for costs of recovery but for exhaustion of mineral assets alone"; a taxpayer is not entitled, "in addition to a depletion allowance on his

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[4] Petitioner, without elaboration, asserts conflict by way of footnote (Pet. 11, n. 1) with *Fort Howard Paper Co.* v. *Commissioner*, 49 T.C. 275, and *Marsh Fork Coal Co.* v. *Lucas*, 42 F. 2d 83 (C.A. 4). *Fort Howard* noted that the taxpayer's method was not in derogation of any provision of the Internal Revenue Code, and *Marsh Fork* stressed that successive Treasury Regulations had permitted the accounting practice involved. These factors are not present here.

minerals, [to] a similar allowance on his manufacturing costs, including depreciation on his manufacturing plant, machinery and facilities." In line with these decisions, it is settled that the depletable "gross income from the property" of an oil and gas producer is "only so much of the proceeds from the sale of the gas as he would have received had he sold the gas at the wellhead." *Hugoton Production Co.* v. *United States*, 315 F. 2d 868, 869 (Ct. Cl.); *Brea Cannon Oil Co.* v. *Commissioner*, 77 F. 2d 67 (C.A. 9); *Consumer Natural Gas Co.* v. *Commissioner*, 78 F. 2d 161 (C.A. 2).

In *Shamrock Oil & Gas Corp.* v. *Commissioner*, 346 F. 2d 377 (C.A. 5), the taxpayer, like petitioner, applied absorption and other processes to its raw wet gas, and contended that the values added by these processes were part of its depletable income. The Fifth Circuit rejected this contention, concluding that the taxpayer was entitled to depletion only on the basis of a representative market or field price for its raw gas. It specifically held that the absorption process was a conversion or manufacturing process, stating (346 F. 2d at 380):

> Although the absorption process here may have been essential from a marketing viewpoint, it was in no sense essential to *production*, any more than it can be said that the fractionation process was essential to production. Both were designed and operated to separate the raw gas into its various component parts for marketing purposes. What Shamrock produced was raw gas.[5]

[5] Proposed Treasury Regulations, 33 Fed. Reg., Part 10, pp. 14707-14708, Section 1.613-3(a)(3)(i), defines conversion or manu-

It is apparent from the quoted language that *Shamrock* cannot be distinguished on the ground that the taxpayer in that case proceeded to fractionate its liquefied hydrocarbons into gasoline and other products. Nor would any such distinction be permitted by *Cannelton*, where it was held that there can be no discrimination between mineral producers as to the point where their extractive processes end; they end where the ordinary mineral operator is ready to ship and sell his crude mineral, regardless of the extent, if any, to which they or other producers may thereafter apply manufacturing processes to their minerals. Cf. Breeding & Burton, *Income Taxation of Oil and Gas Production*, par. 11.10, p. 1112. There is thus no basis for petitioner's claims of conflict (Pet. 17-22) with the principles of *Cannelton* and with the decision in *Shamrock*.

Moreover, the Fifth Circuit in *Shamrock* properly distinguished cases where the absorption processes were bound up with and essential to production. See, *e.g.*, *Weinert's Estate* v. *Commissioner*, 294 F. 2d 750 (C.A. 5); *Scofield* v. *La Gloria Oil and Gas Co.*, 268 F. 2d 699 (C.A. 5). In those cases, as explained in *Shamrock* (346 F. 2d at 379-380), "the absorption process constituted an indispensable part of the severance of the raw gas produced. * * * [T]he dry gas remaining was injected back into the reservoir in order to maintain pressure. The cycling plants, which contained absorption facilities, were essential for continuing production of gas from the wells." That situation does not obtain in the instant case. The absorption processes here were

facturing processes, in the case of gas, as including absorption processes.

not "an indispensable part of the severance of the raw gas produced." They were applied to the raw gas in a central plant, after it had been transported as far as five miles from the wellhead (Pet. App. A-31), in order to produce petitioner's marketable condensate and dry gas.[6]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[6] Petitioner is not helped by the fact that the separation of liquid hydrocarbons from the wet gas by the Inlet Scrubber is treated as part of extraction. Such separation is a purely mechanical matter, usually accomplished at the wellhead, of draining off condensate which has formed naturally, without the application of any process.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *

* * * * *

SEC. 263. CAPITAL EXPENDITURES.

(a) *General Rule.*—No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. * * *

* * * * *

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

* * * * *

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) *General Rule.*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) *Exceptions.*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

SEC. 613. [1964 ed.] PERCENTAGE DEPLETION.

(a) [as amended by Sec. 13(c), Revenue Act of 1962, P.L. 87-834, 76 Stat. 960, 1034] *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For purposes of the preceding sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231, and (2) is properly allocable to the property. In no case shall the allow-

ance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

* * * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.162-4 *Repairs.*

The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with section 167 or charged against the depreciation reserve if such an account is kept.

§ 1.263(a)-1 *Capital expenditures; in general.*

(a) Except as otherwise provided in chapter 1 of the Code, no deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or better-

ments made to increase the value of any property or estate, or

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of a deduction for depreciation, amortization, or depletion.

(b) In general, the amounts referred to in paragraph (a) of this section include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the meaning of subparagraphs (1) and (2) of this paragraph. See section 162 and § 1.162-4.

* * * * * *

§ 1.613-3 *Gross income from the property.*

(a). *Oil and gas wells.* In the case of oil and gas wells, "gross income from the property", as used in section 613(c)(1), means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field

price of the oil or gas before conversion or transportation.

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